

89-666

Supreme Court, U.S.

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CLERK

No. _____

In The
Supreme Court of the United States
October Term, 1989

WEST VIRGINIA STATE MEDICAL ASSOCIATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

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QUESTION PRESENTED

Whether the publishing of paid advertising by the West Virginia State Medical Association, a 501(c)(6) tax exempt organization, in its professional journal is a trade or business in which advertising losses can be deducted.

PARTIES TO THE PROCEEDING

Pursuant to Rule 21.1(b), Petitioner states that the caption of this case contains the names of all the parties. Pursuant to Rule 28.1, Petitioner states it has no parent companies, subsidiaries, except wholly owned subsidiaries, or affiliates.

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**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT**

RELIEF REQUESTED

West Virginia State Medical Association petitions for a Writ of Certiorari to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit entered on August 16, 1989.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit rendered on August 16, 1989, is reported in ___ F.2d ___. Appendix, Page 1.

The opinion of the United States Tax Court is reported in 91 T.C. No. 41 (1988). Appendix, Page 6.

The decision of the United States Tax Court was entered on October 24, 1988, in accordance with the aforesaid Tax Court opinion. Appendix, Page 20.

STATEMENT OF JURISDICTION

The judgment affirming the ruling of the United States Tax Court by the United States Court of Appeals for the Fourth Circuit was entered on August 16, 1989.

No orders were entered respecting a rehearing and no orders granting an extension of time within which to petition for certiorari were entered.

Petitioner is unaware of any cross petitions to be filed in this case.

Jurisdiction in this Court is provided by 28 U.S.C. § 1254 and 28 U.S.C. § 2101.

CITATION OF STATUTES AND REGULATIONS

A. I.R.C. § 501(c)(6).

(c) LIST OF EXEMPT ORGANIZATIONS. – The following organizations are referred to in subsection (a):

(6) Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

B. I.R.C. § 513(c).

(c) ADVERTISING, ETC., ACTIVITIES. – For purposes of this section, the term “trade or business” includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

C. Reg. 1.512(a)-1(a).

Definition. – (a) In general. Except as otherwise provided in § 1.512(a)-3, § 1.512(a)-4, or paragraph (f) of this section, section 512(a)(1) defines “unrelated taxable income” as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in § 1.512(b)-1. To be deductible in computing unrelated business taxable

income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be "directly connected with" the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. For the treatment of amounts of income or loss of common trust funds, see § 1.584-2(c)(3).

D. Reg. 1.512(a)-1(f)(2)(i).

Computation of unrelated business taxable income attributable to sale of advertising – (i) Excess advertising costs. If the direct advertising costs of an exempt organization periodical (determined under subparagraph (6)(ii) of this paragraph) exceed gross advertising income (determined under subparagraph (3)(ii) of this paragraph), such excess shall be allowable as a deduction in determining unrelated business taxable income from any unrelated trade or business activity carried on by the organization.

E. Reg. 1.513-1(a).

Definition of unrelated trade or business. - (a) In general. As used in section 512 the term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of "unrelated trade or business" applicable to certain trusts, see section 513(b).) Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if (1) it is income from trade or business, (2) such trade or business is regularly carried on by the organization, and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

STATEMENT OF FACTS

The West Virginia State Medical Association (hereinafter Association) is a business league exempt from federal income taxation under Internal Revenue Code § 501(c)(6). (For purposes of this case, citations are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated). As part of its activities, Petitioner publishes the West Virginia Medical Journal, a monthly magazine publication which is circulated to its members. The Journal consists of two (2) to four (4) scientific articles per issue concerning medical topics of interest to its members, together with general news, reports of actions and activities. In addition to the articles and listings, the Journal publishes paid advertisements.

Advertising space in the Journal is sold to any advertiser who wishes to sell a legitimate product and service within the realm of decency and good taste. Most of the advertisements are for either health or medical products, together with other products which advertisers believe may be of interest to physicians.

The Association regularly kept business records, maintained a professional staff for the Journal and devoted substantial time to the Journal's publication. The Association retained certified public accountants who annually prepared Petitioner's income tax returns and audited its books and records.

The books and records of the Association show that for the year 1983, the Journal had direct advertising costs in excess of its gross advertising income in the amount of Twenty One Thousand Eight Hundred Ten Dollars (\$21,810.00). The advertising loss was applied to offset

Nine Thousand Nine Hundred Eight Dollars (\$9,908.00) of unrelated business taxable income received from I.C. Collection Systems. (The books and records show losses for years prior to and subsequent to 1983. Accordingly, the issue transcends the 1983 tax losses subject to this action.)

The Internal Revenue Service disallowed the deduction for losses from the publishing of paid advertising and determined a tax deficiency of One Thousand Three Hundred Thirty Six Dollars (\$1,336.00). The Tax Court and United States Court of Appeals for the Fourth Circuit upheld the Internal Revenue Service's disallowance of the deduction for losses from publishing paid advertising.

The Tax Court sustained the disallowance of the advertising losses by holding the advertising activity of the Association in the Journal could not be deemed to be a trade or business. See Appendix, Page 19. The United States Court of Appeals for the Fourth Circuit disallowed the losses from publishing paid advertising by holding that whether publishing paid advertising was a trade or business was not the determinative factor; the Court further held that the advertising business conducted by the Association's Journal was not the kind of trade or business in which losses were considered deductible. See Appendix, Page 4.

STATEMENT OF BASIS FOR JURISDICTION IN THE FEDERAL COURTS BELOW

The United States Tax Court had a basis for jurisdiction in this matter pursuant to 26 U.S.C. § 6212 and § 6213. The United States Circuit Court of Appeals for the Fourth Circuit had federal jurisdiction based upon 26 U.S.C. § 7482 and 7483, together with Rule 13 of the Federal Rules of Appellate Procedure.

ARGUMENT

THE PUBLISHING OF PAID ADVERTISING BY THE ASSOCIATION IN ITS JOURNAL IS A TRADE OR BUSINESS AND LOSSES THEREFROM ARE DEDUCTIBLE AGAINST ITS OTHER TRADE OR BUSINESS INCOME.

This Court, in *United States v. American College of Physicians*, 475 U.S. 834, 84 L.Ed.2d 841, 106 S.Ct. 1591 (1986), set forth the parameters and standards determining that publishing of paid advertising in a professional journal by a tax exempt organization is a trade or business.

Gross income from the publication of paid advertising by a tax exempt organization is taxable if: (1) the publication of paid advertising is a trade or business, (2) the business is regularly carried on, and (3) the publication of the paid advertising is not substantially related to petitioner's tax exempt purpose. See *American College of Physicians*, *supra* at 838, 839; Reg. 1.513-1(a).

In the present case there is no question that the business of publishing paid advertising was regularly

carried on and was not substantially related to the Association's tax exempt purpose. Therefore, the only question remaining for decision is whether or not the publication of paid advertising by the Association was a trade or business.

The holding by the United States Tax Court that publishing of paid advertising is not a trade or business and the holding of the United States Court of Appeals for the Fourth Circuit that publishing of paid advertising is not a trade or business in which the losses can be deducted are clearly contrary to the holding of this Court in *American College of Physicians, Id.* The decisions below are also in conflict with the Seventh Circuit's decision in *Fraternal Order of Police, Illinois State Troopers Lodge No. 41 vs. Commissioner*, 833 F.2d 717 (7th Cir. 1987), which opinion is faithful to this Court's decision in *American College of Physicians*.

With regard to the trade or business requirement, this Court, in a unanimous opinion, said as follows:

"Satisfaction of the first condition (that publication of paid advertising is a trade or business) is conceded in this case, as it must be, because Congress has declared unambiguously that the publication of paid advertising is a trade or business activity distinct from the publication of accompanying educational articles and editorial comment". (Emphasis Added).

American College of Physicians, supra at 839.

In *Fraternal Order of Police, supra*, the Seventh Circuit, in analyzing the precise issue presented below regarding

the trade or business requirement of I.R.C. § 513(c), followed this Court's decision in *American College of Physicians, supra*, and reached a contrary result to that rendered by the Fourth Circuit Court of Appeals in this case. With regard to the trade or business requirement, the Seventh Circuit relied upon *American College of Physicians, supra*, and stated:

"The Supreme Court has recently removed any remaining doubts on whether paid advertising constitutes a 'trade or business' under section 513(c)." See *F.O.P., supra* at 722.

In analyzing I.R.C. § 513(c), which relates to advertising activities by tax exempt organizations and which was passed by Congress in the Tax Reform Act of 1969 Pub.L. 91-172, 83 Stat. 487 (1969 Act), this Court said as follows:

"*The statute clearly established advertising as a trade or business, the first prong of the inquiry into the taxation of unrelated business income*". (Emphasis Added).

See *American College of Physicians, supra* at 840.

The regulations issued by the Commissioner of Internal Revenue clearly allow and mandate the deduction of losses incurred in publishing paid advertising from other unrelated business taxable income carried on by a tax exempt organization. Reg. 1.512(a)-1(a), in part, states as follows:

". . . In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions

allowed *with respect to all such unrelated business activities.*" (Emphasis Added).

The above regulation is consistent with the interpretation of the Commissioner in Reg. 1.512(a)-1(f)(2)(i), which in part, reads as follows:

"(i) Excess Advertising Costs. If the direct advertising costs of an exempt organization periodical . . . exceed gross advertising income . . . , such excess shall be allowable as a deduction in determining unrelated business taxable income from any unrelated trade or business activity carried on by the organization".

Based upon the foregoing regulations, it is clear that losses generated by the Petitioner Association in publishing paid advertising are deductible against the income from its other unrelated trade or businesses, if the publication of paid advertising by the Association in its Journal is a trade or business.

The United States Tax Court held that the publication of paid advertising by the Association is not a trade or business and the United States Court of Appeals for the Fourth Circuit affirmed that decision. Those holdings are clearly contrary to this Court's analysis in *American College of Physicians*, and the holding of the Seventh Circuit in *Fraternal Order of Police*.

CONCLUSION

The decision of the United States Tax Court, as affirmed by the Court of Appeals for the Fourth Circuit, that publishing of paid advertising by the Association in

its professional Journal is not a trade or business is incorrect as a matter of law and is contrary to the holding of this Court in *American College of Physicians* and the Seventh Circuit in *Fraternal Order of Police*. Although this Court has dispositively spoken on the trade or business issue and the deductibility of the losses is clearly addressed in the regulations, the Fourth Circuit Court of Appeals and Seventh Circuit Court of Appeals have conflicting views on the trade or business requirement. The Fourth Circuit's position is not consonant with the teaching of this Court in *American College of Physicians* and Petitioner requests this Court correct the error below. Accordingly, this Court should address the issue of the deductibility of losses and settle the conflicting decisions between the Circuits regarding the trade or business requirement and grant this Petition for Writ of Certiorari.

-Respectfully submitted,

West Virginia State Medical
Association

By Counsel

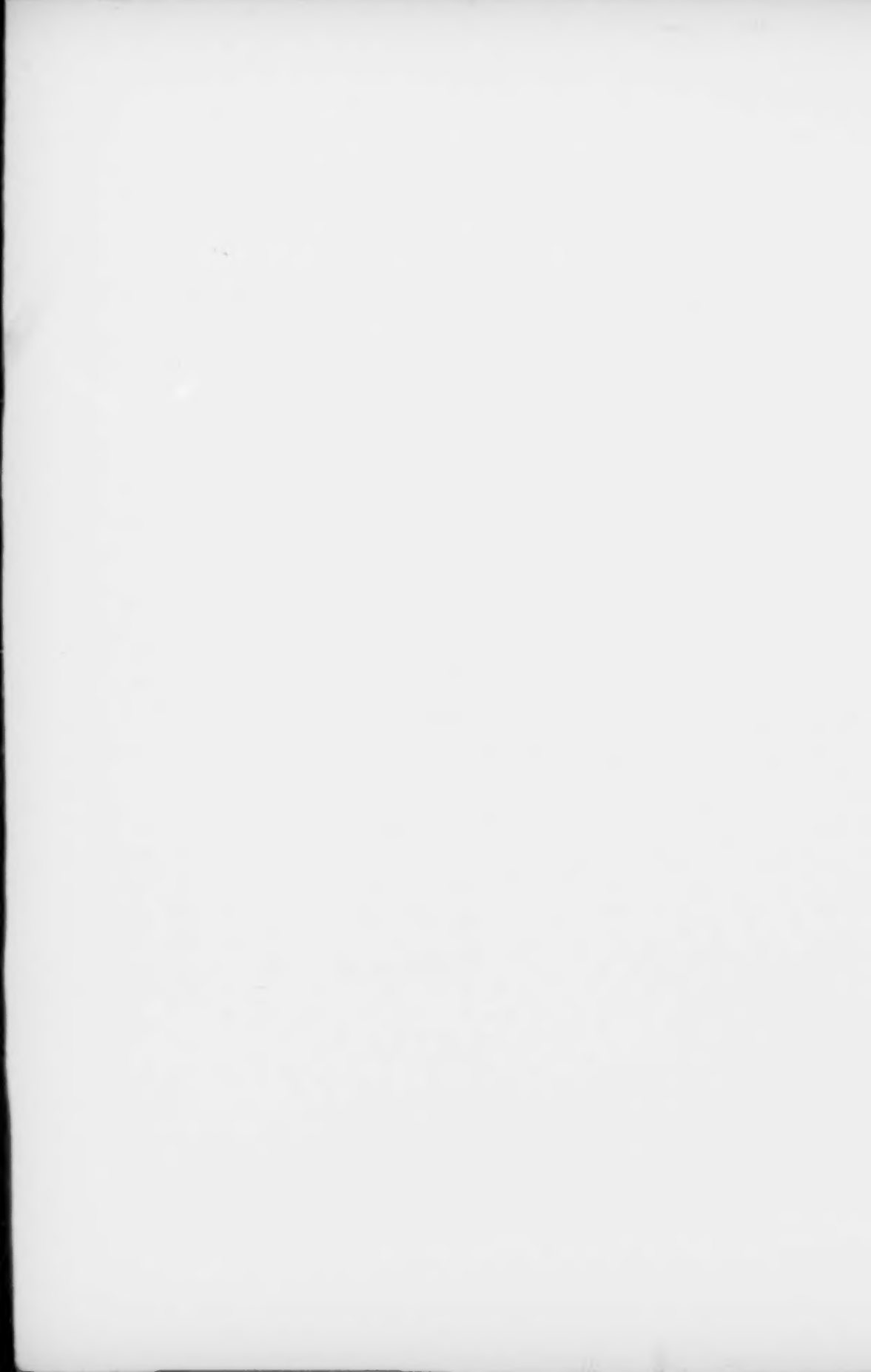
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APPENDIX

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- A. West Virginia State Medical Association v.
Commissioner of Internal Revenue, ___ F.2d ___,
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- B. West Virginia State Medical Association v.
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41 (Opinion filed September 20, 1988)App. 6
- C. West Virginia State Medical Association v.
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Decision entered October 24, 1988App. 20



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APPENDIX
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 88-2984

WEST VIRGINIA STATE
MEDICAL ASSOCIATION

Petitioner – Appellant

v.

COMMISSIONER OF
INTERNAL REVENUE

Respondent – Appellee

Appeal from the United States Tax Court. William M. Fay,
Tax Court Judge. (Tax Ct. No. 3746-86).

Argued: June 8, 1989

Decided: August 16, 1989

Before RUSSELL and SPROUSE, Circuit Judges, and
VOORHEES, United States District Judge for the Western
District of North Carolina, sitting by designation.

George S. Bennett (John T. Kay, Jr., KAY, CASTO &
CHANEY on brief) for Appellant. Kenneth L. Greene
(James I. Knapp, Acting Assistant Attorney General; Gary
R. Allen; Robert S. Pomerance, Tax Division, DEPART-
MENT OF JUSTICE on brief) for Appellee.

SPROUSE, Circuit Judge:

The West Virginia Medical Association appeals from
a judgment of the United States Tax Court holding that it
was liable for income tax in the amount of \$1,336 for

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1983. 91 T.C. No. 41 (1988). The tax court held that the Internal Revenue Service ("IRS") properly disallowed a claimed deduction for losses sustained by the Association's medical journal in the advertising fragment of its "unrelated" business activity. We affirm.

The Medical Association membership consists of physicians practicing in West Virginia, and the Association qualifies as a business league exempt from federal income taxation under Internal Revenue Code § 501(c)(6). As part of its exempt purpose, the Association publishes a monthly medical journal which is circulated to its members. The journal sells advertising space to providers of medical products and services to physicians, but it has not made a net profit on its advertising activities since 1962. Between 1974 and 1986 it incurred annual losses ranging from \$18,874 to \$63,786.

In addition to the journal's advertising income, the Association receives income from other activities that are not related to its exempt purposes, and this income is taxable as unrelated business taxable income. *See* I.R.C. §§ 501(b), 511-513. On its 1983 income tax return, the Association reported that it had received commissions amounting to \$9,908 from endorsing and marketing the services of a company whose business is collecting delinquent accounts. In that same year the Association also suffered a \$21,810 loss from the advertising activity of its journal. On the tax return, the Association offset this loss against the income received from the collection agency, thereby reporting no income from its two non-exempt activities. The IRS disallowed the deduction for loss and determination a tax deficiency of \$1,336. The tax court upheld the IRS's action, ruling that the deduction for the advertising loss was correctly disallowed because the advertising fragment of the journal's activity was not a

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trade or business carried on for profit. The Association appeals, and we affirm.

The Association contends that it is entitled to deduct the losses from advertising, regardless of whether the activity was for profit, because I.R.C. § 513(c) creates a statutory rule that any advertising activity by an other wise tax-exempt organization is a "trade or business," both for the purpose of imposing an income tax on its profits and for allowing a deduction and offsetting its losses against other income. Alternatively, it argues that, at most, in order to permit deductible losses, its advertising activity need only be carried on for the production of gross income. The IRS, however, contends that a tax-exempt organization's § 513(c) unrelated trade or business activity must also satisfy the requirements of § 162 if income from that activity is to qualify as "unrelated business taxable income" under I.R.C. § 512(c)(1). We agree with the IRS.

The Association is exempt from income tax under I.R.C. § 501(c)(6). I.R.C. §§ 501(b) and 511, however, impose an income tax on "unrelated business taxable income" generated by a "trade or business" carried on by tax-exempt organizations that is unrelated to their exempt purposes. "Unrelated business taxable income" is defined by section 512(a)(1) as "the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business. . . ."

In our view, the plain language of section 512(a)(1) indicates not only an intent to tax income generated by an unrelated "trade or business" operated by an exempt organization but also limits deductions against such income to those "*which are directly connected with the carrying on of such trade or business.*" (Emphasis supplied.) We agree with the tax court that the phrase "trade or business" in section 512(a)(1) has the same meaning as in section 162, which generally authorizes deductions for expenses incurred in "carrying on any trade or business." See *North Ridge Country Club v. Commissioner*, 57 U.S.L.W. 2744 (9th Cir. June 1989), No. 88-7062; *Brook, Inc. v. Commissioner*, 799 F.2d 833, 840-41 (2d Cir. 1986); and *Cleveland Athletic Club, Inc. v. United States*, 779 F.2d 1160, 1165 (6th Cir. 1985), which all reach the same conclusion.*

The determinative factor then is not whether advertising generally is a trade or business, see § 513(c) and *United States v. American College of Physicians*, 475 U.S. 834 (1986), but whether the advertising business conducted

* *Cleveland*, *Brook*, and *North Ridge* all involved the deductibility of losses by tax-exempt social clubs engaging in unrelated activities. Social clubs are given tax exempt status by section 501(c)(7), and taxable income received by those organizations is defined in § 512(a)(3) rather than in 512(a)(1). *Cleveland* held that the difference the language of 512(a)(1) and 512(a)(3) required the allowance of deductions for unrelated business activities of social clubs. *Brook* and *North Ridge* reached a contrary result. The Second, Sixth and Ninth Circuits all agreed, however, that deductions incurred by losses from unrelated business activities by § 501(c)(6) organizations, such as the Association, are to be determined in the same manner as "trade or business" allowances under section 162.

by the Association's journal is the kind of trade or business in which losses are considered deductible under the "for profit" rationale of § 162, *i.e.*, that the activity for which a loss is incurred was entered into primarily for profit. See *Commissioner v. Groetzinger*, 480 U.S. 23, 25 (1987) and *United States v. American Bar Endowment*, 477 U.S. 105, 110, n.1 (1986).

The Association had incurred direct advertising costs resulting in substantial losses for twenty-one consecutive years, and has failed to explain why it consistently incurred losses that could have been avoided by simply discontinuing the advertising activity. The tax court correctly concluded that the Association's long-standing policy of voluntarily incurring losses evidenced a lack of profit objective underlying the loss-generating activity. The judgment of the tax court, therefore, is affirmed.

AFFIRMED

UNITED STATES TAX COURT

WEST VIRGINIA STATE MEDICAL ASSOCIATION, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3746-86. Filed September 20, 1988.

P, a medical association exempt from income tax under section 501(c)(6), I.R.C. 1954, publishes a medical journal as part of its exempt purpose. P sells advertising within such journal. Direct advertising costs of the journal exceeded gross advertising revenue. P also receives revenue, distinct from its advertising revenue, in the form commissions for endorsing and marketing the services of a third party.

Held: (1) To compute its unrelated business taxable income, P may offset the income from its endorsement activities with the losses from its advertising activities only if the advertising activity is a trade or business.

(2) P's advertising activity is not a trade or business because P lacks a profit objective in conducting such activity.

George S. Bennett, for the petitioner.

James B. Martin, for the respondent.

OPINION

FAY, Judge: These cases were assigned to Special Trial Judge Hu S. Vandervort pursuant to the provisions of section 7456(d)(3) of the Code (redesignated section 7443A(b)(3) by section 1556 of the Tax Reform Act of

1986, Pub. L. 99-514, 100 Stat. 2755) and Rule 180 et seq. of the Tax Court Rules of Practice and Procedure.¹ The Court agrees with the adopts the opinion of the Special Trial Judge, which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

VANDERVORT, *Special Trial Judge*: Respondent determined a deficiency in petitioner's Federal income tax for its 1983 taxable year, in the amount of \$1,336. The issues for decision are:

A. Whether an exempt organization may, in calculating its unrelated business taxable income, offset the income from one unrelated activity with the losses from another unrelated activity; and,

B. Whether the advertising activities which petitioner conducted in its business league journal constitute a trade or business.

FINDINGS OF FACT

Some of the facts have been stipulated. This reference incorporates the stipulation of facts and attached exhibits.

Petitioner was a corporation with its principal office in Charleston, West Virginia when it filed the petition in this case.

¹ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue and all rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner, a business league exempt from Federal income taxation under section 501(c)(6), is a medical association whose members are physicians practicing in West Virginia. Its exempt purpose is to "federate * * * the entire medical profession of the State of West Virginia * * * and to extend medical knowledge, advance medical science, and promote public health." As part of its exempt purpose, petitioner publishes the West Virginia Medical Journal (Journal), a monthly magazine which is circulated to its members. Merwyn G. Scholten (Scholten), who testified at trial, is the Executive Director of petitioner and, in the past, has been the Executive Editor of the Journal.²

The Journal consists of two to four scientific articles per issue concerning medical topics of interest to the members. General news and reports of actions and activities, whether governmental or social, are also listed in the Journal. In addition to the articles and listings, the Journal carries paid advertisements.

The Journal sells space to "any advertiser who wishes to sell a legitimate product and service within the realm of decency and good taste." While most of the advertisements are for either health or medical products, other products which may be of interest to physicians are also advertised in the Journal. Public service advertisements are published at no cost if space is available.

The majority of the Journal's advertisements are prepared professionally and arrive as set copy ready for

² Mr. Scholten became Executive Director on April 23, 1984, subsequent to the year in issue. His predecessor is now deceased.

print. Frequently, pharmaceutical advertisements arrive as printed inserts which are then placed into the Journal. In addition, the Journal will occasionally set type for a local advertiser.

During the relevant period, petitioner regularly kept business records, maintained a professional staff for the Journal, and devoted substantial time to its publication. From 1980 to 1985, printing labor costs increased 25 percent, paper costs increased 27 percent, and other costs increased from 3 to 5 percent. In an attempt to counter this, the Journal considered proposals and bids from competing printers which were lower than its current printer. The Journal, however, decided not to change because its current printer was close to its offices.

Along with other state medical journals, the Journal is a member of the State Medical Journal Advertising Bureau (Bureau). The Bureau's purpose is to solicit advertisements from major pharmaceutical companies and other national advertisers on behalf of its members. For its services, the Bureau is paid a commission for advertising copy placed in its members' journals.

Although the Bureau sells most advertising space nationally, petitioner has sent letters to pharmaceutical firms and other national firms to solicit advertisements independent of the Bureau. In addition, petitioner has made efforts to increase local advertising.

The Bureau annually sends rate surveys to its members to establish the cost to the advertiser per thousand readers, a standard industry measure. The results of the rate surveys are then used by the Bureau's members to analyze and determine their advertising rates. In addition

to using these rate surveys, the Journal considers its own cost factors to determine the price of advertising.

In the early 1960's Senator Estes Kefauver chaired Senate Subcommittee hearings (Kefauver hearings) to investigate whether Merrill Pharmaceuticals withheld information on the side effects of certain products. As a result of the Kefauver hearings, Congress moved to strengthen the Food and Drug Administration and restricted advertising for newly developed drugs. Following the Congressional action, pharmaceutical advertising in medical journals declined and has never recovered.

Petitioner has claimed the following losses from its advertising activity in the Journal:

<u>YEAR</u>	<u>AMOUNT OF LOSS</u>
1974	\$25,125.00
1975	33,858.00
1976	63,786.00
1977	19,829.00
1978	22,646.00
1979	36,165.00
1980	39,807.00
1981	41,741.00
1982	42,042.00
1983	21,810.00 ³
1984	29,707.00
1985	18,874.00
1986	20,087.00

Moreover, petitioner has not made a profit on its advertising activity since 1962.

Separate from its advertising activity, petitioner also received revenue in 1983 from I.C. Collection Systems, a

³ Year at issue.

national organization that collects overdue accounts for doctors. During 1983, I.C. Collection Systems paid petitioner a \$9,908 commission for endorsing and marketing its collection services.⁴

In 1983, and Journal reported \$33,163 in gross advertising income and deducted \$54,973 direct advertising costs which resulted in a \$21,810 loss. This loss was applied to offset the \$9,908 unrelated business taxable income received from I.C. Collection Systems in 1983. Respondent determined that such an offset is impermissible.

OPINION

The issues for decision are:

A. Whether an exempt organization may, in calculating its unrelated business taxable income, offset the income from one unrelated activity with the losses from another unrelated activity; and,

B. Whether the advertising activities which petitioner conducted in its business league journal constitute a trade or business.

Petitioner is a medical association exempt from Federal income taxation under 501(c)(6). See section 1.501(c)(6)-1, Income Tax Regs. An exempt association recognizes neither income nor losses related to its exempt purpose. Section 501(a). Income from a trade or business which is unrelated to its exempt purpose, however, is

⁴ In years subsequent to 1983, petitioner has also received income from its endorsement of a national insurance carrier.

taxed as unrelated business taxable income. Sections 501(b) and 511.

Unrelated business taxable income is defined as income derived from any unrelated trade or business regularly carried on by the exempt association. Section 512(a)(1). An unrelated trade or business is defined as a trade or business, the conduct of which is not substantially related to the exercise or performance of the exempt organization's purpose. Section 513(a). Accordingly, an exempt association's activity is subject to unrelated business tax under section 511 if:

- (1) The income is derived from a "trade or business";
- (2) The trade or business is regularly carried on by the organization; and
- (3) The conduct of the trade or business bears no substantial relation (other than through the production of funds) to the organization's exempt purpose.

Section 1.513-1(a), Income Tax Regs.; see *United States v. American College of Physicians*, 475 U.S. 834 (1986); *United States v. American Bar Endowment*, 477 U.S. 105 (1986); *Florida Trucking Association v. Commissioner*, 87 T.C. 1039 (1986); *Fraternal Order of Police v. Commissioner*, 87 T.C. 747 (1986), affd. 833 F.2d 717 (7th Cir. 1987).

The taxation of business income not substantially related to the objectives of an exempt organization dates from the Revenue Act of 1950 (1950 Act). Prior law had allowed exempt organizations to use profits from unrelated activities to further their exempt purposes without regard to the source of those profits. See *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924). As

a result of this prior law, exempt organizations were able to compete with corporations whose profits were fully taxable. That is, exempt organizations were able to use their profits to expand operations, while their nonexempt competitors could expand only with the profits remaining after taxes.

Congress viewed this as an unfair advantage to exempt organizations and enacted the 1950 Act to eliminate the unfair competition that the tax laws had created. See *United States v. American College of Physicians*, *supra*; S. Rept. 2375, 81st Cong., 2d Sess. (1950), 1950-2 C.B. 483, 504-505. In doing so, however, Congress did not force exempt organizations to abandon commercial ventures. Rather, Congress imposed a tax on the unrelated business taxable income of exempt organizations with the hope of encouraging exempt enterprises while restraining unfair competition for non-exempt businesses. Section 511(a)(1); *United States v. American College of Physicians*, *supra*.

In 1967, regulations were promulgated that interpreted the unrelated business income provisions of the 1950 Act. The regulations defined "trade or business" to include not only a complete business enterprise, but also any component activity of a business. Section 1.513-1(b), Income Tax Regs. This approach is commonly referred to as "fragmenting" the enterprise into its component parts.

Fragmenting a trade or business of a publication such as a trade journal had a significant effect on advertising, which had previously been considered simply a part of a unified publishing business. The new regulation segregated the "trade or business" of selling advertising

space from the "trade or business" of publishing a journal, and thus treated each activity as an unrelated trade or business activity. In the promulgated regulations, the Treasury Department stated:

In general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 – and which, in addition, is not substantially related to the performance of exempt functions – presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of service. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and goodwill which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not identify a trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. * * * *activities of soliciting, selling, and publishing commercial advertising do not lose identity as trade or business even though the advertising is published in an exempt periodical which contains editorial matter related to the exempt purposes of the organization.* * * * [Section 1.513-1(b), Income Tax Regs.; emphasis supplied.]

Congress, in the Tax Reform Act of 1969 (1969 Act), specifically endorsed the proposed concept of "fragmenting" the publishing enterprise into its component activities. In fact, the 1969 Act adopted much of the language of the regulation that defined advertising as a separate trade or business. Following the 1969 Act, section 513(c) provided:

Advertising, Etc., Activities. – For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sales of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

Section 513(c) was amended, effective January 1, 1970. The House committee report issued in connection with the amended section stated:

Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. It has concluded that by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore it believes that this income should be taxed.

Under this provision, it is anticipated that advertising income from publications (whether or not the publications are related to the exempt purpose of the organization) will constitute unrelated business income to the extent it exceeds the expenses related to the advertising, and, if the editorial aspects of publication are carried on at a loss, to the extent it exceeds this loss. * * * H. Rept. 91-413 (1969), 1969-3 C.B. 199, 232.

Also in connection with the 1969 Act, the Senate committee made the following comments:

The committee agrees with the House that the regulations reached an appropriate result in specifying that when an exempt organization carries on an advertising business in competition with other taxpaying advertising businesses, it should pay a tax on the advertising income. * * * For this reason, the committee agrees with the House that the regulations, insofar as they apply to advertising and related activities, should be placed in the tax laws. [S. Rept. 91-552 (1969), 1969-3 C.B. 423, 472.]

After reviewing the legislative history, we conclude that to determine whether losses from an unrelated activity may be used to reduce the exempt organization's unrelated business taxable income, the activity must be held to the same trade or business standard as a non-exempt organization activity. To hold otherwise would allow an exempt organization to receive a benefit not available to a non-exempt organization, from an activity which is in direct competition with the non-exempt organization's activities. Such benefit to the exempt organization would be a lower aggregate tax liability for all of its unrelated business activities. This is the precise result

Congress intended to avoid. Accordingly, advertising losses from the Journal may offset petitioner's unrelated business taxable income only if, in the first instance, it is held that the advertising activity is a trade or business. Section 1.512(a)-1(f), Income Tax Regs.

Whether an exempt organization can offset a loss from a non-exempt activity against income from another non-exempt activity, where the loss activity is not a trade or business because of the lack of profit objective, has been addressed in the Sixth Circuit and Second Circuit, which reached diametrically opposed results. Both of the circuit cases arose in the context of social clubs exempt from tax under section 501(c)(7).

In *Cleveland Athletic Club v. United States*, 779 F.2d 1160 (6th Cir. 1985), the Sixth Circuit held that a social club could offset the loss created by excess expenses against other income to determine its unrelated business taxable income, even though the loss activity lacked a profit objective. The court held that ordinary and necessary business expenses are allowed to be deducted against unrelated business taxable income where the basic purpose of the activity is economic gain and that a profit motive is not required.

In *The Brook, Inc. v. Commissioner*, 799 F.2d 833 (2d Cir. 1986), affg. in result a Memorandum Opinion of this Court, the Second Circuit expressly rejected the "economic gain" test and adopted a traditional "trade or business" test. The court held that a social club could not offset a loss from one activity against other unrelated business taxable income absent a profit motive in respect of the loss activity.

We do not have to resolve the conflict between the Sixth and Second Circuits since those cases involved social clubs under section 501(c)(7), and turned on section 512(a)(3)(A), rather than a business league under section 501(c)(6), which implicates section 512(a)(1). See *North Ridge Country Club v. Commissioner*, 89 T.C. 563 (1987), on appeal (9th Cir., Jan. 29, 1988). We note, however, that both circuits state, albeit in dicta, that the lack of a profit objective with respect to one activity would preclude, under section 512(a)(1), the offset of losses from that activity against income from another activity which does have a profit objective.

An activity of an exempt organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute a trade or business within the meaning of section 162 is a trade or business for purposes of the tax on unrelated business income. Section 1.513-1(b), Income Tax Regs. To be a trade or business, the taxpayer must be involved in the activity in question with continuity and regularity and "the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Commissioner v. Groetzinger*, 480 U.S. 23, ___ (1987). See also section 513(c).

It is not disputed that petitioner is a section 501(c)(6) exempt organization, or that its advertising activity was not substantially related to its exempt purpose. Further, it is agreed that the direct advertising costs were allocated correctly and were ordinary and necessary. Finally, it is agreed that petitioner was involved in its advertising activity in the Journal continuously and regularly. The issue, then, is whether the advertising activity was

engaged in primarily for income or profit.⁵ Petitioner bears the burden of proving that the advertising activity was entered into for profit. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a).

Generally, advertising is a means to generate revenue. Petitioner, however, has chosen to incur direct advertising costs that have exceeded advertising revenue for 21 consecutive years. Petitioner has failed to explain why it has consistently incurred losses that could have been avoided had it discontinued the advertising activity.

The advertising activity losses evidence a lack of profit objective and, accordingly, such activity cannot be deemed to be a trade or business. See section 1.183-2(b)(6), Income Tax Regs.; *Golanty v. Commissioner*, 72 T.C. 411, 416 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981); *Besseney v. Commissioner*, 45 T.C. 261 (1965), affd. 379 F.2d 252 (2d Cir.), cert. denied 389 U.S. 931 (1967). Accordingly, the Journal's advertising losses may not be used to reduce the unrelated business income.

Decision will be entered for the respondent.

⁵ Whether petitioner published the Journal as a trade or business is not relevant since it is deemed to be an exempt function. See *United States v. American College of Physicians*, 475 U.S. 834 (1986).

App. 20

UNITED STATES TAX COURT
Washington, D.C. 20217

WEST VIRGINIA STATE)	
MEDICAL ASSOCIATION,)	
)	
Petitioner,)	
)	
v.)	Docket No. 3746-86
COMMISSIONER OF)	
INTERNAL REVENUE,)	
)	
Respondent.)	

DECISION

Pursuant to the determination of the Court as set forth in 91 T.C. No. 41, filed September 20, 1988, it is

ORDERED and DECIDED that there is a deficiency in petitioner's Federal income tax for the taxable year 1983 in the amount of \$1,336.

/s/ William M. Fay
William M. Fay
Judge

Entered: October 24 1988



(2)
No. 89-666

Supreme Court, U.S.

FILED

DEC 18 1989

JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1989

WEST VIRGINIA STATE MEDICAL ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

**ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT**

BRIEF FOR THE RESPONDENT IN OPPOSITION

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14 AP

QUESTION PRESENTED

Whether a loss incurred by a tax-exempt medical association from selling advertising space in its professional journal may be offset against its taxable income derived from another source, where it does not engage in the advertising activity with the intent to produce a profit.



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In the Supreme Court of the United States

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*ON PETITION FOR A WRIT OF CERTIORARI
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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-5) is reported at 882 F.2d 123. The opinion of the Tax Court (Pet. App. 6-19) is reported at 91 T.C. 651.

JURISDICTION

The judgment of the court of appeals was entered on August 16, 1989. The petition for a writ of certiorari was filed on October 12, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a medical association that is exempt from federal income tax as a "business league," pursuant to Sec-

tion 501(c)(6) of the Internal Revenue Code.¹ Like other tax-exempt organizations, however, it is subject to tax on income unrelated to its exempt purposes, pursuant to Sections 511-513 of the Code.² In furtherance of its exempt purpose, petitioner publishes a monthly medical journal that is circulated to its members. It sells advertising space in the journal to providers of medical products and services; the sale of advertising space is not related to its exempt purpose. Petitioner has not made a net profit from its advertising activity since 1962. During the 1974-1986 period, it incurred annual losses from that activity ranging from \$18,874 to \$63,786. Apart from its advertising activity, petitioner receives commission income from endorsing and marketing the services of a company that collects delinquent accounts for physicians. This marketing activity is not related to petitioner's exempt purpose. Pet. App. 8, 10-11.

On its 1983 federal income tax return, petitioner reported commission income of \$9,908. It also reported \$33,163 in gross advertising income, from which it deducted \$54,973

¹ Unless otherwise noted, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.) (the Code or I.R.C.), as in effect during 1983, the tax year involved.

² These provisions impose a tax, at regular corporate rates, on the "unrelated business taxable income" of otherwise tax-exempt organizations. For a business league, the phrase "unrelated business taxable income" is defined by Section 512(a)(1) to mean "the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business." Section 513(a) defines an "unrelated trade or business" as "any trade or business the conduct of which is not substantially related * * * to the exercise or performance by such organization of its [exempt function]." Section 513(c) defines a "trade or business" as "any activity which is carried on for the production of income from the sale of goods or the performance of services."

of advertising costs, resulting in a loss of \$21,810 from its advertising activity for 1983. Petitioner then offset the advertising loss against its commission income and reported zero unrelated business income tax liability for 1983. The Commissioner determined that, because its advertising activity was not a trade or business entered into for profit, petitioner's advertising expenses were deductible only up to the amount of its gross income from that activity; therefore, the loss from petitioner's advertising activity could not offset its unrelated business income from commissions.³ Pet. App. 2, 10-11.

2. Petitioner sought redetermination of the resulting \$1,336 deficiency in the Tax Court, which upheld the Commissioner's determination (Pet. App. 6-19). The court reasoned that the phrase "trade or business" as used in Section 512(a)(1) has the same meaning as in Section 162 of the Code, which generally authorizes deductions for non-exempt organizations for expenses incurred in "carrying on any trade or business." See Pet. App. 16. Quoting *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), the court observed that, to be a trade or business for purposes of Section 162, "the taxpayer's primary purpose for engaging in the activity must be for income or profit" (Pet. App. 18). The court found that petitioner's history of 21 consecutive years of losses, coupled with its failure to explain why it continued to incur losses that could have been avoided if it discontinued the advertising activity, established that peti-

³ This determination reflects the general rule under the income tax law that the expenses of a not-for-profit activity may be offset against the income from that activity, but excess expenses may not be applied against income from other sources. See I.R.C. § 183; *Five Lakes Outing Club v. United States*, 468 F.2d 443, 446 (8th Cir. 1972) (allowance of expenses up to, but not exceeding, gross income from not-for-profit activity is "the procedure the Commissioner has long used with court approval").

tioner did not engage in that activity for profit. *Id.* at 19. Accordingly, the court concluded that petitioner's advertising activity was not a trade or business for purposes of Section 512(a)(1) and, therefore, that petitioner could not deduct against other unrelated business income the excess expenses incurred in conducting that activity.

3. The court of appeals affirmed (Pet. App. 1-5). The court agreed with the Tax Court's analysis that the phrase "trade or business" has the same meaning in Section 512(a)(1) as in Section 162, and therefore that the deductibility of petitioner's loss from advertising depends upon whether the loss resulted from an activity that is conducted with the intent of making a profit. In so holding, the court rejected petitioner's contention that advertising activity conducted by an exempt organization is automatically a "trade or business" under Section 512, irrespective of the existence of a profit motive. The court explained (Pet. App. 4-5): "The determinative factor then is not whether advertising generally is a trade or business, * * * but whether the advertising business conducted by [petitioner's] journal is the kind of trade or business in which losses are considered deductible under the 'for profit' rationale of § 162, *i.e.*, that the activity for which a loss is incurred was entered into primarily for profit." Applying that standard, the court agreed with the Tax Court's finding that petitioner had failed to establish the requisite profit motive for its advertising activity, noting that petitioner had incurred direct advertising costs resulting in substantial losses for 21 consecutive years (Pet. App. 5).

ARGUMENT

Petitioner contends that any advertising activity conducted by an exempt organization necessarily qualifies as a "trade or business" for the purposes of Sections 511-513 of the Code, irrespective of the lack of a profit motive for

the advertising activity. The court of appeals correctly rejected that contention, and its decision does not conflict with any decision of this Court or of another court of appeals. Accordingly, there is no reason for review by this Court.

1. Section 513(c) of the Code defines a "trade or business" for purposes of unrelated business income taxation as "any activity which is carried on for the production of income from the sale of goods or the performance of services." The relevant Treasury Regulation, 26 C.F.R. 1.513-1(b), provides that "in general, any activity of [an exempt] organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' within the meaning of section 162" is a trade or business under Section 513(c). See generally *United States v. American Bar Endowment*, 477 U.S. 105, 110 (1986). As this Court has noted, "[t]he standard test for the existence of a trade or business for purposes of § 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit' " (*id.* at 110 n.1, quoting *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)). Thus, the courts generally have "adopted the 'profit motive' test to determine whether an activity constitutes a trade or business for purposes of the unrelated business income tax." *United States v. American Bar Endowment*, 477 U.S. at 110 n.1 (citing cases). Because the deductions available to petitioner in determining its "unrelated business taxable income" are confined by the language of Section 512(a)(1) to those incurred in a "trade or business," it follows that petitioner may deduct against its commission income the expenses incurred in carrying on its advertising activity only if that advertising activity is carried on with an intent to make a profit. Petitioner, however, does not dispute the factual conclusion of the courts below that it lacked a profit motive for its advertising activity.

Petitioner's contention is that the above principles do not apply to advertising activities, but rather that these activities constitute a "trade or business" under Section 513(c) even in the absence of a profit motive. This contention is clearly belied by the statute. Section 513(c), which is captioned "Advertising, etc., activities," defines a "trade or business" as "any activity which is carried on *for the production of income* from the sale of goods or the performance of services" (emphasis added). Therefore, the statute explicitly contemplates that advertising activity must be profit-motivated in order to constitute a "trade or business." Moreover, a major impetus for the enactment of that provision was the desire to establish that a tax-exempt organization's sale of advertising in a trade or professional journal may be "fragmented" as an activity separate from the publication of the journal's editorial content. See *United States v. American College of Physicians*, 475 U.S. 834, 839-840 (1986).⁴ Thus, there is no basis whatsoever for excepting advertising from the general principles underlying Section 513(c). And the legislative history of the statute confirms what is strongly indicated in its text—namely, that those general principles restrict a tax-exempt organization from reducing its unrelated business taxable income by losses arising from the publication of a journal or other periodical unless the organization carries on the publishing activity with

⁴ Before this statute was enacted in 1969, tax-exempt publishers had argued that the unrelated business income tax did not apply to their advertising profits on the ground that the advertising constituted part of a unified publishing business with a dominant educational (and exempt) purpose. Section 513(c) rejects that argument, and endorses the concept of "fragmentation," by providing that "an activity does not lose identity as a trade or business merely because it is carried on * * * within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."

the intention of producing a net profit. See H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 50-51 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 76 (1969).

2. Contrary to petitioner's contention (Pet. 8-9), nothing in this Court's decision in *United States v. American College of Physicians*, *supra*, suggests that advertising activity can be treated as a "trade or business" if it is not profit-motivated. In contrast to petitioner, the tax-exempt medical association in *American College of Physicians* made a net profit from the sale of advertising space in its journal (see 475 U.S. at 836), and therefore the case did not involve the question presented here of the deductibility of excess expenses in computing unrelated business taxable income under Section 512(a)(1). Rather, the question in that case was whether the profits derived from the advertising, which the association had conceded to be a "trade or business," were exempt from the unrelated business income tax on the ground that the advertising activity was "substantially related" to the organization's educational purposes.

Petitioner thus takes out of context the statements in *American College of Physicians* on which it relies. This Court observed that the enactment of Section 513(c) "established advertising as a trade or business, the first prong of the inquiry into the taxation of unrelated business income." 475 U.S. at 840. Similarly, the Court noted that "[s]atisfaction of the first condition is conceded in this case, as it must be, because Congress has declared unambiguously that the publication of paid advertising is a trade or business activity distinct from the publication of accompanying educational articles and editorial comment" (*id.* at 839). These statements merely explain Congress's acceptance in 1969 of the principle of "fragmentation" as applied to a tax-exempt publisher's advertising profits (see p. 4 and note 4, *supra*) and note that the taxpayer was not contesting the treatment of its advertising activity as a "trade or business"

distinct from the exempt aspects of its publication activity. This Court in *American College of Physicians*, however, clearly did not consider, or purport to give an opinion on, whether the sale of advertising constitutes a trade or business where, as here, it is carried on without a motive to make a profit. Accordingly, there is no conflict between the decision below and this Court's decision in *American College of Physicians*.

Petitioner's claim of a conflict in the circuits is similarly without merit. In *Fraternal Order of Police, Illinois State Troopers, Lodge No. 41 v. Commissioner*, 833 F.2d 717 (7th Cir. 1987), the court of appeals rejected the argument of a tax-exempt association that its advertising should not be regarded as a trade or business under Section 513(c) because it did not result in unfair competition with other advertisers. The court explained that this Court's decision in *American College of Physicians* "recently removed any remaining doubts on whether paid advertising constitutes a 'trade or business' under section 513(c)." 833 F.2d at 722. Like this Court in *American College of Physicians*, the court of appeals made this statement in the course of explaining Congress's adoption of the principle of "fragmentation" and its attendant rejection of the proposition that the placement of advertising in a publication prepared for tax-exempt purposes is a sufficient basis for failing to treat the advertising activity as a "trade or business." As in *American College of Physicians*, the advertising activity of the association in *Fraternal Order of Police* was conducted for profit, and the court had no occasion to consider whether losses from such activity, if it had not been carried on for profit, could be offset against taxable income from another source. Indeed, the court explicitly noted that the existence of a profit motive is the standard test for determining whether an activity constitutes a trade or business (833 F.2d at 722) and proceeded to rely on the association's concession that it "intended to,

and did, profit from the sale" (*id.* at 723). Thus, the Seventh Circuit's decision is fully consistent with the reasoning of the court below.⁵

Petitioner's reliance on the Commissioner's regulations (Pet. 10-11) is similarly misplaced. Treas. Reg. § 1.512(a)-1, which petitioner quotes in part (Pet. 10), specifically states that deductible expenses "must be directly connected with the carrying on of unrelated trade or business." Petitioner's partial quotation of Treas. Reg. § 1.512(a)-1(f)(2)(i) omits the definition by cross-reference of "direct advertising costs"—*i.e.*, "determined under subparagraph (6)(ii) of this

⁵ As the court of appeals noted (Pet. App. 4 n.*), there is a conflict among the circuits concerning the determination of the "unrelated business taxable income" of tax-exempt social clubs under Section 512(a)(3), but that conflict has no bearing here. Compare *Cleveland Athletic Club, Inc. v. United States*, 779 F.2d 1160 (6th Cir. 1985), with *The Brook, Inc. v. Commissioner*, 799 F.2d 833 (2d Cir. 1986), *North Ridge Country Club v. Commissioner*, 877 F.2d 750 (9th Cir. 1989), and *Portland Golf Club v. Commissioner*, No. 88-7218 (9th Cir. Mar. 6, 1989), petition for cert. pending, No. 89-530. These cases involve the question of the correct method for determining whether the exempt organization has a profit motive in engaging in a particular activity. Specifically, in these cases, the clubs earned gross income from certain activity unrelated to their exempt purposes (the sale of food and drink to nonmembers), but reported losses from that activity because their total expenses, including a portion of the fixed overhead allocated to that activity, exceeded the gross income. The courts of appeals have divided on the merits of the clubs' argument that, despite these losses, they had the requisite profit motive in conducting the activity in question because they intended that the gross income from the nonmember activity would exceed the *variable* expenses, albeit not all of the expenses (both fixed and variable) allocable to that activity. All of these courts agree, however, that the existence of a profit motive is a prerequisite to the deduction under Section 512(a)(1) of excess expenses arising from a particular activity (see Pet. App. 4 n.*, 18), and therefore all of these courts would have rejected the contention of petitioner, which has not argued that it conducted its advertising activity with the motive of earning a profit.

paragraph." That subparagraph in turn specifies that these costs "are allowable as deductions in the computation of unrelated business income * * * to the extent they meet the requirements of section 162, section 167 [which allows a deduction for the depreciation of property used in a trade or business] or other relevant provisions of the Code." Treas. Reg. § 1.512(a)-1(f)(6)(ii). Thus, like Section 512(a)(1) itself, the regulations manifestly do not allow petitioner to deduct advertising costs that exceed its gross income from advertising unless its advertising activity is conducted for profit, and therefore qualifies as a trade or business for purposes of the income tax provisions of the Code.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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DECEMBER 1989

